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SUBJECT: Application of the recent California Supreme Court decisions in General Motors v. Franchise Tax Board and Microsoft v. Franchise Tax Board to determine the amount of gross receipts derived from treasury function activities and whether the inclusion of these receipts in the sales factor results in an unfair reflection of income.

QUESTION PRESENTED

How should audit apply these recent decisions of the California Supreme Court to ongoing audits involving treasury function issues?

CONCLUSIONS

1. Auditors should continue to apply the distortion analysis set forth in Appeal of Pacific Telephone (78-SBE-028). While Microsoft adds additional tools regarding the factual inquiry into whether the apportionment formula fairly represents the activities of the taxpayer in the state, the court also cited favorably to Pacific Telephone in reaching its decision. Therefore, the analysis found in Pacific Telephone is still applicable. In addition, auditors should endeavor to develop facts to apply the Court's new analysis based on a comparison of profit margins.
2. There is no "bright line" test for distortion; each case must be analyzed based on its own facts and circumstances. Clearly if the facts presented by a taxpayer closely resemble the facts in Pacific Telephone or Microsoft, the taxpayer's gross receipts from its treasury function should be reduced to net income, for both maturities and sales prior to maturity, on the basis of section 25137. However, as outlined in detail below, the distortion inquiry should not be limited to the methodology of these cases, nor should either case be

viewed as establishing a "floor" for the application of an alternative apportionment formula. Based on the analysis by the Court, it may be appropriate to utilize an alternate apportionment formula in some cases exhibiting changes in the factor that are smaller than the changes in those cases.

3. If the facts in a given case show distortion resulting from the application of the standard formula, the auditor should take the position that an alternative apportionment formula is warranted ***
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ANALYSIS AND DISCUSSION

The California Supreme Court recently issued its opinions in General Motors v. Franchise Tax Board and Microsoft v. Franchise Tax Board. These opinions are still subject to change and there are rehearing petitions that have been filed in both cases. Despite this, there is a need to provide guidance on how these cases impact current policies regarding the gross receipts/treasury function issue. Therefore, this TAM is intended to provide interim guidance on the two cases and is subject to changes if the opinions themselves are altered.

The two cases both addressed aspects of the gross receipts/treasury function issue, but in different factual contexts. The General Motors opinion addressed the narrow issue of the proper amount of "gross receipts" includable in the sales factor from GM's investments in repurchase agreements. The Microsoft decision is broader and analyzed what was the proper amount of "gross receipts" derived from marketable securities held to maturity. In addition, Microsoft addressed the application of section 25137 to reduce the "gross receipts" from a treasury function activity to net income. Because these cases are related, it is best to analyze them from a broad perspective first, focusing on the Microsoft opinion, and then a narrower perspective to deal with questions related to the specific receipts analyzed in General Motors.

Microsoft v. Franchise Tax Board

The Court's Microsoft opinion held that, in general terms, the gross receipt from the redemption of a marketable security held to maturity is the total amount received upon the redemption. This effectively was Microsoft's position in its claims for refund. The court rejected the FTB's position that the gross receipt upon redemption should be limited to the interest income received by the taxpayer. Therefore, as a matter of general application, the sales factor should include the total amount received from the disposition of marketable securities, regardless of whether they are sold prior to maturity or are redeemed. This, however, is not the end of the Court's analysis.

The Court went on to ask if the inclusion of all of these gross receipts in the sales factor leads to the factor no longer clearly representing the activities of the taxpayer in the state. The Court held that the inclusion *does* lead to a distortion that should be remedied under section 25137. The Court's analysis followed the prior existing case law. The Court cited extensively from the SBE opinion in Appeal of Pacific Telephone (78-SBE-028) and agreed with the analysis of the Board. The Court also cited to the SBE opinion in Appeal of Crisa Corp. (02-SBE-004) stating that in that case "the SBE reiterated that operation of a large treasury department unrelated to a taxpayer's main business is a paradigmatic example of circumstances warranting invocation of section 25137." Therefore, after Microsoft, the preexisting case law in the area, Pacific Telephone and Crisa, remain good law and should be followed. This allows the department to limit the sales factor inclusion of the treasury function activities to net gains on the disposition of a security prior to maturity and reduces maturities to interest income only.

Specifically the auditor should not automatically include sales prior to maturity in the sales factor at gross. These sales are just as excludible under a distortion analysis as securities held to maturity.

However, the Court did not conclude its 25137 analysis at this point. It went on to analyze the underlying cause of the treasury function problem and provided an additional basis upon which to find if an alternative formula was justified. This additional basis is founded upon what the Court described as an "implicit assumption" in UDITPA that a corporation's profit margins will not vary inordinately from state to state. The Court analyzed the profit margin of the treasury function against the profit margin for Microsoft's main line of business and found, not surprisingly, that the treasury function profits were quite low when compared to their gross receipts, while the rest of the business had a much higher profit margin. The Court concluded, "modern corporate treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation's business pose a problem". The Court found that FTB's solution to this problem, inclusion only to the extent of net income generated by the treasury function, was reasonable.

After Microsoft, there are now additional tools to aid in a showing of distortion. First, the Court sanctioned the analysis set forth in Pacific Telephone and Crisa, which focused qualitatively on the nature of the treasury function activity (number of employees, amount of income, nature of the business) and then analyzed the quantitative effect of this ancillary activity on the assignment of income through the apportionment formula. Second, the Court also sanctioned a comparison of the profit margins from an ancillary activity to the profit margins of the main line of business, as an additional method to show that the normal formula fails to fairly represent the activities of the taxpayer in the state. Therefore, in analyzing treasury function cases[1] in the future, the FTB staff should similarly include an analysis of the profit margins issue in addition to the factual development already necessary to apply the qualitative analysis set forth in Pacific Telephone and Crisa.

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[1] It is important to note that Microsoft is a treasury function case. **************************************
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In performing the profit margin analysis, auditors should be aware that the Court utilized a comparison of net income to gross receipts. While this comparison was illustrative of the distortion given the facts of the case, it will not be a valid comparison in a case where the taxpayer's main line of business produced very little net income or a loss. This is because the Court's analysis is essentially a comparison of a gross income number for the treasury function's income verses a net income number for the main line of business' income. In a case where the net income from the main line of business is very low, but the gross profit margins (gross receipts minus cost of goods sold) is high, the auditor should perform the analysis based on gross income compared to gross receipts. This comparison is more likely to provide insight into the relative profitability of the various activities because both income numbers (the treasury function income and the main line income) are not reduced for costs. The alternative would be to assign expenses to the treasury function, such as interest expense, payroll and overhead costs, in order to better approximate a net income number for the treasury function. Clearly this would be a more time intensive approach[2].

The application of this new tool will inevitably lead to questions regarding the level of profit margin disparity that should trigger the application of section 25137. Unfortunately, there is no bright line test set forth in the opinion. The Court merely stated that the treasury function was *qualitatively different* from the rest of Microsoft's business, and that the profit margins from the treasury function were *quantitatively "several orders of magnitude"* different from the rest of Microsoft's business. Therefore, factual development remains key to the application of section 25137 and each case should continue to be analyzed individually to determine whether the activity in question is qualitatively ancillary as well as quantitatively large enough in effect to merit the use of an alternative formula. The numbers cited by the Court in Microsoft, as well as the numbers cited by the Board in Pacific Telephone, while illustrative, are not bright lines. Even though a given case may have income and gross receipts numbers lower than that of Microsoft or Pacific Telephone, this does not mean the inclusion of the treasury function at gross receipts is proper.[3] If the auditor believes that the facts in a given case show distortion resulting from the application of the standard formula, the auditor should take the position that an alternative apportionment formula is warranted ***************************************
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General Motors v. Franchise Tax Board

In General Motors, the California Supreme Court noted two baseline observations. One, that "in a sale of marketable securities the entire sale price constitutes gross receipts" and the other that "the repayment of a loan is never considered a receipt." The Court also found that one must look to the "economic reality" of the transaction involved to determine whether the transaction involves a sale of securities (in which case the entire sales price, including returned principal,

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[2] Some corporations place the treasury function into a separate subsidiary. If so, they may have assigned officer's compensation, payroll and benefits, interest expense, rent and corporate overhead to the subsidiary. In this situation it might be reasonable to compare the net income (federal 1120, line 28) of the treasury function subsidiary to the net income (federal 1120, line 28) of the unitary group's main line of business.

[3] It should be noted that the while the Court imposed the burden of proof on the FTB regarding the application of section 25137, the facts typically relied on by FTB in making the 25137 adjustment were held to meet this burden.

constitutes a “gross receipt” for sales factor purposes), or a loan (in which case only the interest income received constitutes a gross receipt for sales factor purposes).

Applying these principles, the Court in General Motors held that the taxpayer’s repurchase agreement transactions, which constituted approximately 90% of the transactions at issue in General Motors, were in economic substance merely loans, and that, therefore, only the interest income component of those loan transactions constituted a gross receipt. ***************
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While the General Motors decision left unanswered specifically which investments fall into the "loan" category and which fall into the "marketable securities" category, there is some additional insight available from the decision. The Court clearly held that redemptions of Treasury Bills held to maturity fall into the "marketable securities" category and therefore the total amount received at either sale or redemption is a gross receipt. *******************************
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*** it is very important that the facts are fully developed regarding the composition of the investments included in the sales factor. **
*******. Auditors reduce the receipts from repurchase agreements to interest income and not reduce the receipts from any other transactions unless clearly classifiable as a loan. If a taxpayer argues that a given investment is a loan, then the auditor should develop the facts ************
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In performing the factual development, auditors should inquire into each type of instrument, the amount of receipts claimed to arise from that instrument, and the gross margin for each instrument. In addition, the auditor should determine whether the instrument bears interest by its terms, whether the taxpayer entered into the transaction directly with the issuer and specifically what the terms of the instrument provide. The auditor should try to determine if the instrument is marketable, how it is treated for book purposes, and any other facts that the auditor feels might impact the analysis.

Tax Counsel